COMMENTARY

IS THIS REALLY NECESSARY?

NO FAILURES AFTER THE S&L CRISIS? DON'T BANK ON IT

Well, the director of the Federal Deposit Insurance Corporation was on "Nightline" again the other night. Trying to calm troubled waters, aware that lack of confidence can lead to panic which can lead to mass withdrawals, in turn justifying the panic, and in self-fulfilling fashion, spawning more of it.

The discussion on the talk shows and in the popular press is depressingly ill-informed about basic economics. The January 8 "Nightline" sequence consisted of an expert repeating the need for "early intervention" to take over troubled banks more quickly. Journalist Jane Bryant Quinn opined that intervention is needed to save the banks, and that there is little other choice or little one can do but pay because they are "so important to all of us." And the entire discussion became a consensus nod that the only danger would be a "taxpayer bailout" such as is occurring with the savings and loan industry.

So this becomes a problem only if general fund monies are tapped? How is it that our pundits, including those who cover this industry, are so blind to basic economics? Why is the role of special insurance funds such as the FDIC, or its tragic sister FSLIC, so little understood? [Of course, the more discerning among us (and since you are reading this publication, you are certainly included) have long been aware that many of our visible pundits, as professional pontificators, make up only in false bravado and arrogant certitude what they lack in knowledge.]

Let's establish a few basics. First, the FDIC is supposed to insure the first $100,000 in each depositor's account. So the Bank of New England is in trouble...what is the FDIC doing? It takes over the bank and assumes its bad loans, to be borne by its insurance Fund, in order to make it an asset attractive for purchase by another bank. That is not insuring the first $100,000 in deposits of each depositor—that is bailing out the *big* depositors, the whole operation, at a cost of around $3 billion. Three billion dollars is a lot of money. But, the experts assure us, that doesn't matter because it comes from the Fund; the real concern is whether the taxpayer will have to pay to replenish *the Fund* if its contributors can't.

Wrong. We are also the Fund.

The FDIC is created by contributions from banks. Its sustenance does not drop from the skies as manna. The contributions are compelled and operate as an industry-wide tax. Any fee imposed across an entire industry is largely paid by the consumers of the services involved. It is a pass-through. We pay for this fund in our credit card charges—now at what, more than *twice* the prime rate, in lower bank interest rates payable to us, in automatic teller charges, in checking account charges, in higher home loans, points, and other fees the banks charge us. The amount is spread out to most of us, probably to a larger number than feed the general fund everyone focuses on. It seems to be an American affliction: a tax is not a tax if it is not called a tax and I do not actually see the money taken away at a counter or written as a check to the IRS or Franchise Tax Board or the local County Treasurer.

So let's get things straight...we are paying for the FDIC Fund. That is our money in there. If it requires replenishment from the banks, the bank stockholders will not pay very much of it at all; it will be passed on to us as consumers of this industry, and that means most all of us.

The second thing the pundits do not understand is how insurance works to socialize risk, and how it affects incentives and profit-directed activity. When the FDIC totally bails out the Bank of New England, it is not operating as a Fund to assure $100,000 protection so widows and orphans do not lose their homes. No, it is going to be used (probably improperly, maybe illegally) to bail out anyone who fails and to protect all depositors of that institution. And who pays? Depositors of *all* institutions, including those who banked at slightly lower interest rates received from banks which were a bit more conservative and sensible.

Here is the flaw in undifferentiated socialization of risk by such a Fund. It creates a false incentive to take risks. It encourages foolhardy risk. It...guarantees no loss. It is not a no-lose proposition, but it is too close to one. If a bank's crazy loans, junk bonds, or South American Amazon road financing ventures make it, it makes a fortune. The executives continue on with their million-dollar salary/bonus packages. The stockholders see their shares double in value. If, however, the bank loses and the gamble goes the path of Pete Rose Way, the bank does not have to worry about the IRS, or the U.S. Attorney, or bankruptcy, or the total loss of the equity investment by its stockholder owners. No. The Fund will take over its losers and it will skate with little or no loss. Heads I win, tails I don't lose. [Of course, this description is not universally applicable; the Fund will not bail out small local banks heavily investing in their local communities, only the big high flyers...because, as Jane Bryant Quinn will tell you, these banks, which she has covered for some time, are very important.]

As a banker, if you do *not* join this parade of gamblers, you are assured of losing. Because some of the gamblers are winning, and they are therefore attracting capital. They are your competitors, and you are rather compelled to gamble yourself.

The tough question is, how do you solve this problem? How do you create an industry able to attract capital, give security to accountholders, and yet not create false incentives to risk?

The public discussion thus far has been pathetic. As is normal in these circumstances, you have knee-jerk partisans for drum-tight regulation; and then you have the University of Chicago deregulators, who worship a marketplace existing only in the imaginations of theorists. They would simply deregulate, as if they were deregulating into some kind of neutral "natural order."

And if any of you are unfortunate enough to discuss these issues in front of a legislative body, you'll see the zenith of this kind of parodied "it has to be one or the other." The Republicans stubbornly urge deregulation, pointing to bureaucratic stifling of *any* risk as inhibiting investment in banks and savings and loans. And the Democrats cite the horrors of the deregulation of the airline and S&L industries to argue for "regulation." And all you get from them is a big YES to regulation or a big NO.

What is lost in this rhetorical discussion by partisans is the fact that there are many, many different *kinds* of regulation. Indeed, contrary to the conservative shibboleths, the executive branch is not the only intervenor. Absent the executive branch, there are still commercial rules of practice, a common law, mores, statutes, a court system. There would be a lot of regulation of banking even if there were no banking regulators. The conservatives are right that, all other things being equal, less regulation is better; put differently, if we can let the self-correcting efficiency of the marketplace regulate, let's do it. The issue is *how* we regulate and who does it, and which way works better at lower system cost.

Should we eliminate FDIC insurance? No. It performs a useful social function. People should not suffer total annihilation of the last of their savings because they made an error in choosing their banker. The information is too imperfect to the consumer, the consequences too great, and the complicity of the state too extensive in granting charters and assuring solvency. But why not change the system to inhibit the cross-subsidy of the loser by the responsible—funded really by all of us? Why not establish some ground rules to make the system work without gratuitously preventing capitalization?

Here is our list of defensible reforms: they do not bespeak a "regulate" or a "deregulate" panacea. Rather, they are designed to accomplish public protection through a mix of effective but minimally intrusive incentives and interventions.

1. Insure 80% of the first $200,000, and limit the $200,000 to a per individual maximum. The purpose of FDIC insurance is to soften the catastrophic blow to those who cannot legitimately judge the solvency of these institutions. As amounts climb above the current $100,000 and beyond, the ability to judge the institution increases and the deposit takes on a less personal character and becomes more commercial. What social gain is there in requiring persons to inefficiently place holdings in twenty different institutions, and why should someone able to do so receive protection meant for those facing impoverishment if there is a failure?

However, insure only 80% so the depositors take *some* risk and have some incentive not to give their money to an institution which will use it on excessively risky ventures. This change raises the ceiling to up to $160,000 per individual, more than the current $100,000. But it provides the proper incentive for every person, while removing currently prevalent coverage outside the intent of the Fund.

2. Vary required contributions to the FDIC Fund based on the degree of risk in the kinds of loans and investments made. Insurance firms do this all the time in the private sector. Your dune buggy may well have a higher premium than a safer vehicle of the same value. A person who acts to minimize risk normally receives a lower premium. Obviously, it may not be possible to fine-tune such premium variation with precision, but some basic rules and risk categories should trigger higher contributions.

3. The Fund must not be used to relieve uncovered depositors, or the bank's stockholders. Do not violate the Fund's basic purpose by using it to pick up the entire tab, as the FDIC is regrettably doing for the Bank of New England. It is critical to require the stockholders to pay a serious price for the failure. They are the ones who own the bank; they picked the directors who chose the management who made the decisions—all operating to advance the financial welfare of themselves. If the FDIC is to make the mistake of seizing, rectifying, and selling, it must be arranged so the existing stockholders not only receive no dividends, but pay the brunt of the diminution in value.

Apart from incentives, we may be able to take some precautionary measures. The next level of worthy measures has to do with early warning and information.

4. Repeal the overly solicitous exemptions of financial institutions from the disclosure requirements of the federal Freedom of Information Act, the California Public Records Act, and related statutes. These exemptions deprive the public of current information about the financial condition of regulated institutions. At present, it is considered refined thinking to keep the public in the blind about a teetering enterprise. "If you let people know there may be a problem by opening up the bank's condition to the public, then a small blip of a problem will create a panic and generate the very collapse you want to avoid."[1] Let us say that we have heard that line before, and it is, in reality, disingenuous. As a nine-year white collar crime prosecutor, this author has heard that line repeatedly, universally, by the defenders and even the victims of Ponzi schemes. "Don't blow the whistle yet, just a few more sales and it will all turn out...this is just a bad blip." In the vast majority of financial institution failures, the sum result of this approach has been to secrete from new depositors and investors important information about the institution in which they are putting their money; and it almost invariably leads to a lot more people drowning on a sinking ship. Quite often, more people board the swamped vessel after the leak than were on it before it sprung. The newcomers are defrauded in order to bail out those on board. Our answer: fine, but let them know the condition of the boat.

Contrary to the theory of the defenders of paternalistic secrecy, disclosure will not mean instant panic. There would be some instant panic now because of a self-fulfilling prophecy: little information is released publicly and when it happens it is too late and always means disaster. If information *were* available earlier and became routine, a small problem would yield what the market always yields—a small response; a bigger problem would yield a bigger response. In other words, use the market here, too. Let people choose; let them know.[2]

5. Establish meaningful accounting rules. Abandonment of the traditional Generally Accepted Accounting Principles (GAAP) for Regulatory Accounting Principles (RAP) helped to disguise the weaknesses of savings and loan institutions from the public and regulators. Tighten definitions in GAAP and apply them with independence and fidelity. The pattern of reporting assets at values wildly disparate from market measures has impeded early warning of trouble.

6.Establish an affirmative duty on accountants to report financial condition in a proper and professional manner; add an affirmative duty to report to a regulator any attempt to alter or secrete evidence of financial condition in a way likely to mislead; prosecute those who violate this obligation both civilly and criminally, and revoke their licenses. Accountants have been knowing accomplices in the savings and loan debacle. Touche Ross & Co., now merged with Deloitte, Haskins & Sells, has been sued for failure to examine properly the records of Beverly Hills Savings & Loan; the former Deloitte, Haskins & Sells was accused of negligence for its work with Sunrise Savings & Loan in Florida; Coopers & Lybrand is now defending its audit of a borrower in a suit brought by Freedom Savings & Loan; Ernst & Young has been accused of false audits for financial institutions in Tennessee.[3] The FDIC itself now has thirty lawsuits pending against accounting firms. Another 1,400 investigations of savings and loans are under way. Do not think bank accounting suffers from a different professional standard. The accused firms are among the leading accounting partnerships in the nation.

Although the imminent likely comeuppance may have some cautionary effect on the profession, it will not be sufficient. For an accounting firm faces an immediate and certain pay-off for its silence, and a risk only if things turn south. And, if it reports accurately, it may believe that its reports will themselves turn things south—with a prior history of its own reassurances sitting on the record. Accounting firms are trapped in their own false incentives to play along. In order to have preventive information of the kind needed, they must be required to report and given immunity for it.

The accountancy profession is one which has focused traditionally on barring entry into its ranks [it has often maintained an examination passage rate of below 20%]; and on cartel practices to enhance the exclusivity of its services [see the following Commentary detailing current self-serving efforts by the CPA profession in California, now being challenged in *Moore v. Board of Accountancy*]. It is a profession whose *raison d'etre* is the reliable and consistent certification of financial condition. If it is relied upon to accomplish that end, and it consistently fails to do so, then its presence in this world may be a net harm; it is better to know there is no reliable assurance than to think there is when there is not. Since what it does has potential benefit, it should be required to provide that benefit as a prerequisite to continued status as a defined profession.

7. Hold attorneys liable for violation of ethical rules; disbar those who violate them. It is somewhat more difficult to require attorneys to report affirmatively the wrongdoing of their clients because of the traditional attorney-client privilege. But they should not be let off so quickly. First, that privilege does not apply to continuing crimes. Most of the financial manipulations risking the assets of financial institutions are arranged by counsel...and they are indeed continuing crimes in which counsel participate. It is appropriate to criminally prosecute attorneys involved in such schemes, to hold their assets civilly liable, and to disbar them as warranted. Second, attorneys are not only allowed to resign as counsel where unlawful acts are occurring against their advice; current Rules of Professional Conduct *require* them to so resign.[4]

The FDIC currently has 25 lawsuits pending against law firms, some of them among our largest. For example, Jones, Day, Reavis & Pogue has just been sued for $149 million for its involvement with two failed Texas thrifts. A great deal of work must be done about attorney honesty.

8. Categorically prohibit self-dealing by directors, managers, and other fiduciaries of bank assets. Those who manage a bank have a very special fiduciary duty to depositors and—because of federal insurance—to taxpayers. As we discuss below, impediments to business judgment should not be imposed without thinking through their impact on the ability to attract capital and provide—yes, dare we say it—important banking services. But prohibiting self-dealing in a broad categorical brush is a preventive measure with little inhibiting effect on legitimate investment. If a person has a legitimate loan application, he or she can go elsewhere.

9. Invest modestly in regulatory agencies to monitor financial institutions, with a focus on early warning and preventive regulatory strategies. The savings and loan and banking regulatory staffs are pathetically underfunded in California. The Department of Savings and Loan had about 42 effective staff during the most tragic financial debacle in the nation's (and state's) history.[5] Be assured that having a large staff does not of itself guarantee effective monitoring or regulation. The Department of Insurance has a staff of over 600, and those of us who have been watching it over the past decade would be hard put to list much of anything it has done historically warranting its resources. [It disapproved of exactly one cartel-set insurance premium rate in the decade prior to the passage of Proposition 103; engaged in practically no rulemaking; and ignored 4,000 annual consumer complaints.[6]] But although the Insurance Department's record would daunt even an agency-worshipping liberal, opposition to an adequate staff assures that there cannot be effective regulation. Better to have no regulation than a facade upon which people will rely. Either regulate right or do not do it.

Another group of restraints goes beyond changing incentives and providing early warning. Some of these have been implemented with the federal Financial Institutions Reform, Recovery and Enforcement Act of 1989 (FIRREA) reforms directed particularly at savings and loans.[7] Here, we want to be careful. We do not want to regulate reflexively. It is possible that a particular abuse will be prevented by simply prohibiting the entire category of behavior related to it, but at what cost? These measures deserve discussion, but not thoughtless replication. We would opt for the above-described measures as a higher priority, and turn to these only as a last resort, and then impose them in rifle-like fashion as narrowly drawn as will be effective. These measures include controls or limits on ownership (*e.g.*, only in-state, a minimum number of stockholders, only a given percent control by any one person or family); prohibition of brokered deposits; capitalization requirements; reserve requirements; and investment limits.

Certainly there must be some minimum measure of security. For when the public backs the assets of a bank, which it certainly does through the FDIC, it has a right to security. In the same way the bank itself properly demands collateral, so do the people to protect their investment. But the public should not be so foolhardy as to require so much security that the supply of services and capital is unduly restricted. This is a delicate balance.

It seems anomalous perhaps, but allowing banks to engage in certain other businesses, and to invest and function across a wide geographic area, is generally well-advised—with several *caveats*. It is well-advised because operating across a spectrum of enterprises and locales may spread the risk, and may allow capital to go to where it is most needed by market criteria. And operating other businesses, such as insurance services, has other societal advantages. For example, the insurance industry has been immune from antitrust law for two generations. The Insurance Services Office, Inc. (ISO) has formulated cartel rules and practices to enhance premiums and promote common insurance contract terms. In November 1988, Proposition 103 carried out the recommendations of Republican and Democratic Presidential blue-ribbon commissions, and largely removed the antitrust exemption for insurance in California. But old habits die hard. Where an industry has been ensconced in the comfort of cartel arrangement, particularly for lines of insurance where there are only 1-10 carriers (which includes many of them), the inertial effects of a longstanding commercial custom not to compete may carry forward.[8] So allowing a large institution such as a bank to compete may break up such comfortable arrangements and provide real competition and consumer benefit.

As for the *caveats*, there are at least two. First, watch for market abuse by the banks along traditional antitrust lines. Be careful to preclude "tie-ins," prohibited by antitrust law. For example, do not let banks condition a new account on buying insurance from them as well.

Second, make sure that the required reserves and capitalization are separate and distinct from any such venture. Public utility regulators call this "keeping it below the line." If a bank has adequate reserves in government paper, make sure they are *not* borrowed against or otherwise encumbered by any such risk-creating venture. In the same way a bank will not allow you to put a first trust deed in front of the trust deed it has on your house, we cannot permit it to put anyone between us and the assets we rightfully require to protect our investment in it.

Let there be no mistake about it: contrary to the pundits, we have an investment in the banks through the FDIC directly; we don't have to wait for a taxpayer bailout. We are the Fund. And until the public makes the regulators aware that it knows more than the professional prognosticators, and demands the creation of incentives based on real economics to protect public assets, we shall remain in hands in which we best not bank.

FOOTNOTES

1. This is the rationale used to justify the exemption of records of financial institutions filed by the regulated institution with state and federal regulators from the disclosure requirements of the federal Freedom of Information Act, *see* 5 U.S.C. § 552(b)(8), and the California Public Records Act, *see* Government Code § 6254(d)(1).

2. The government's current strategy is to keep them in the dark. When the Center for Public Interest Law recently attempted to get information from the Department of Insurance about the condition of a troubled insurance company, one would have thought we were blueprinting the Poseidon warhead. After DOI refused CPIL's Public Records Act request, CPIL filed suit, *Belth v. Gillespie*, No. 923654 (San Francisco Superior Court, filed Sept. 10, 1990), to obtain the requested records—documents reflecting the Insurance Commissioner's approval of a $45 million transfer from Executive Life Insurance Company to its parent, First Executive Corporation. Although records of this type do not fall within the Public Records Act exemption for financial information filed with the regulator by the regulated institution (or the similar Insurance Code section 1215.7), DOI turned the records over only after suit was filed and only because First Executive acceded to the request.

3. And finally, belatedly, in November 1990, the state Board of Accountancy filed an accusation seeking to revoke the California license of Ernst & Young, alleging gross negligence in its audits of Lincoln Savings & Loan and its parent company, American Continental Corporation.

4. See Rule 3-700(B)(1).

5. Statement of William J. Crawford, California Savings and Loan Commissioner, in *Savings and Loan Crisis: Field Hearings before the House Comm. on Banking, Finance and Urban Affairs*, 101st Cong., 1st Sess., 426 (Jan. 12-13, 1989). In fiscal year 1989-90, the state Department of Banking had only 135 employees dedicated to the licensing and supervision of banks and trust companies.

6. *See, e.g.*, information on *Bourhis v. Gillespie*, No. 907349 (San Francisco Superior Court, December 1989), in **Cal. Reg. L. Rep**. Vol. 10, No. 1 (Winter 1990) at 110, and Vol. 9, No. 4 (Fall 1989) at 97.

7. Pub. L. No. 101-73, 103 Stat. 183 (1989). For a description of FIRREA's provisions, *see* Oshiro, *Partners in Crime: California's Role in the $335 Billion Savings and Loan Heist*, **Cal. Reg. L. Rep**. Vol. 10, No. 4 (Fall 1990) at 1, 5.

8. Look at the survival of real estate brokerage commissions at 6% of the sale price of a home, 10% of the price of raw land; *see People v. National Ass'n of Realtors*, 120 Cal. App. 3d 459, 174 Cal. Rptr. 728 (1981).

THERE'S NO ACCOUNTING HOW FAR THE BOARD OF ACCOUNTANCY WILL GO

The Board of Accountancy licenses certified public accountants (CPAs). It is comprised of eight practicing Board licensees and four public (nonlicensee) members. Over the past two decades, the Board has not distinguished itself as a source of meaningful professional standards, or as a force disciplining dishonest or incompetent accounting practice. It has been effectively moribund in both capacities, remaining in a limacine stupor as the profession it regulates has failed to sound the warning call in the face of the largest series of accounting frauds in American financial history: the savings and loan debacle. During this profession's torpid somnolence, more damage has been done to more people and is causing more economic harm than all of the previous chicanery in our nation's history combined. The Board's energies, however, have historically been directed at keeping out the infidels, *i.e.*, new competing CPAs. In this area, it has managed to flunk in its examinations 70-90% of those who attempt them.

More recently, this sad excuse for a profession, and sadder excuse for a regulatory body, has stirred from its lethargy in a burst of cartel energy. Controlled by CPAs, it has decided that it will simply prohibit non-CPA accountants—who have practiced lawfully for decades under section 5052 of the Business and Professions Code—from using the terms "accounting" or "accountant" to describe their services. This is a neat trick. Since many individuals and businesses need an accountant but not necessarily a CPA, there is fierce competition between CPAs and other accountants for a significant amount of accountancy business. What better way to remove competition than to prevent those opening the phone book from finding a listing for them? What better trick than to preclude them from using the only words which accurately describe their services? And then the Board used a 1986 law to adopt rules so it could directly cite *non*licensees and impose fines on them—for using a term they have used for decades to describe their services.

This issue is in litigation, and the California Supreme Court recently granted—unanimously—a petition to review the First District Court of Appeal's regrettable decision in *Moore v. California State Board of Accountancy*,[1] a case challenging the Board's authority to impose its proprietary will through the vehicle of the state of California. To fully appreciate the absurdity of this Board's attempt to privatize our State for the narrow aggrandizement of the interest group controlling it, one must review the applicable law and its history in some detail, as well as the constitutional concepts here relevant.

In the Accountancy Act,[2] the legislature has provided that a limited number of accounting tasks (specifically, the preparation of a formal audit with an accompanying certified opinion of soundness) may be performed only by a CPA. In section 5052, it has carved out a significant portion of what can only be characterized as accountancy and expressly allowed non-CPAs to engage in it.

In section 5058, the legislature has specified that only CPAs may use the title "certified public accountant" and a large number of other enumerated accounting titles and abbreviations. On the three occasions the legislature has amended section 5058 in the past 45 years, it has never prohibited the use of the unmodified term "accountant" by nonlicensee independent accountants engaged in accounting activities expressly permitted in section 5052.

In 1948, the Board of Accountancy adopted "Rule 2,"[3] which bars non-CPAs engaged in lawful accounting activity under section 5052 from using the terms "accountant" or "accounting" to describe themselves or their services. The Board has generally failed to enforce Rule 2 until recent years—that is, until the fees for CPA services have soared, putting them out of the reach of the small business owner, the farmer, the sole practitioner, and the individual consumer who needs general accounting services but not the auditing expertise reserved to CPAs by the legislature.

As the volume of accounting business diverted from CPAs to unlicensed accounting practitioners has ballooned, so has the CPA profession's desire to put unlicensed accountants out of business, or at least severely restrict their advertising ability. In particular, CPAs desire to prevent unlicensed accountants from advertising in telephone directories under the heading "Accountant". Rule 2—adopted and now sought to be enforced by a board dominated by CPAs—fulfills this desire.

Aside from the obvious statutory interpretation and commercial speech issues, we would urge consideration of a significant due process issue: where a rulemaking and adjudicatory body consists primarily of licensees belonging to a specific economic grouping (*e.g.*, one type of accountant) in competition with other similar practitioners, is it constitutional for those board members to use the power of the State to adopt and enforce rules of practice to their economic advantage against groups not represented in the relevant tribunal?

CPIL believes that the answer is "no". As discussed below, in *Gibson v. Berryhill*,[4] the U.S. Supreme Court found that the Alabama Board of Optometry (consisting entirely of private-practice licensed optometrists) was an unfair tribunal for purposes of instituting adjudicatory proceedings against competitor licensed optometrists employed by corporations. Similarly, California courts have invalidated portions of the New Motor Vehicle Board Act, the California Forest Practice Act, the Dry Cleaners' Act, and the Barber Act due to the very infirmity present here: the inherent, due process-violative unfairness of an industry-dominated regulatory agency improperly attempting to limit competition and further its own profit-stake interests.[5]

The pending *Moore* case is not solely concerned with rulemaking by a state agency controlled by those with an impermissible pecuniary interest in the proceedings; for the CPA-dominated Board of Accountancy has also attempted to enforce its rulemaking through its adjudicatory authority. Although dormant for many years, the Board's recent enforcement of Rule 2 has taken the form of "cease and desist" letters to unlicensed practitioners, ordering them to refrain from using the terms "accountant," "accounting," or "accountancy" in their advertising, business cards, letterhead, or elsewhere to describe themselves or their work. The Board of Accountancy—which, like other occupational licensing/regulatory agencies, functions as investigator, prosecutor, and judge in adjudicatory proceedings—has aimed its prosecutorial threats at individual unlicensed practitioners, such as plaintiff Bonnie Moore, who provide accounting services to small businesses and individuals. The "cease and desist" letter sent to Moore in the currently pending case included the threat of criminal prosecution. The Center contends that the Board has formulated and applied this rule for cartel enhancement purposes, and that the actions of this unrepresentative, conflict-laden Board are unconstitutional.

Unconstitutional Rulemaking. CPIL believes that the Board is constitutionally disqualified from adopting Rule 2. As noted above, the Board of Accountancy is currently comprised of six certified public accountants, two public accountants, and four public members (none of whom are unlicensed accounting practitioners). When the Board adopted Rule 2 in 1948, it consisted of five licensed accountants.

Rule 2 purports to clarify Business and Professions Code section 5058, which prohibits the use of modified titles likely to be confused with "certified public accountant" and "public accountant":

> No person or partnership shall assume or use the title or designation "chartered accountant," "certified accountant," "enrolled accountant," "registered accountant" or "licensed accountant," or any other title or designation likely to be confused with "certified public accountant" or "public accountant," or any of the abbreviations "C.A.," "E.A.," "R.A.," or "L.A.," or similar abbreviations likely to be confused with "C.P.A., or "P.A."; provided, that any person qualified as a certified public accountant under this chapter who also holds a comparable title granted under the laws of another country may use such title in conjunction with the title of "certified public accountant" or "C.P.A."[6]

Rule 2—as adopted in 1948 and currently—prohibits non-CPAs from using the unmodified terms "accountant," "auditor," "accounting," and "auditing" as well as "any other titles or designations which imply that the individual is engaged in the practice of public accountancy" as "likely to be confused with" the restricted titles. The adoption of this rule by a board dominated by persons with a pecuniary stake in the rulemaking decision, and which is adverse to the interests of unregulated competitors, violates the due process rights of unlicensed accountants who compete with CPAs for accountancy business in the marketplace.

Numerous cases illustrate the principle that members of a multi-member governmental entity may not abuse their agency rulemaking authority to promote their own pecuniary interests. In *Bayside Timber Company, Inc. v. Board of Supervisors of San Mateo County*,[7] the First District Court of Appeal struck down a regulatory scheme mandated by statute, wherein timber operators and loggers were permitted to collude in cartel-like fashion to adopt rules regulating logging in various state districts under the jurisdiction of the State Board of Forestry.

Under Public Resources Code sections 630-31, the State Board of Forestry was comprised of seven members: six were required to be members of timber-related industries, and the seventh member was a public member. The Forest Practice Act, Public Resources Code sections 4521-4618, established regional forest practice committees, each comprised of four timber owners in the region and one Board of Forestry employee who voted only in the event of a tie among the timber owners. The committees were delegated the authority to develop logging policies which, if approved by two-thirds of the timber owners in the district, were submitted to the Board of Forestry for approval. Such policies, if approved by the State Board, had the force of law—much like Rule 2 at issue in the *Moore* case.

Faced with a challenge to the constitutionality of the regulatory scheme established in the Forest Practice Act, the court held that the legislature's standardless delegation of authority to industry-controlled regional committees was "violative of the state and federal Constitutions...and otherwise denies due process of law to the interested and affected public."[8] Concluding that, under the statutory scheme, "the content of the rules under which private logging operations are conducted is decreed exclusively by persons pecuniarily interested in the timber industry, *i.e.*, timber owners and operators,"[9] the First District invalidated the statute, recognizing the "age-old principle of our law that no man should judge or otherwise officially preside over disputed matters in which he has a pecuniary interest."[10]

The *Bayside Timber* court found the presence of non-industry members on the Board of Forestry to be an ineffective safeguard against the heavy bias in favor of logging interests created by the statutory scheme. Additionally, the court found that the interest in protecting against *public* injury (that is, "public injury [which] must inevitably result from placing exclusive control of the logging industry in the hands of persons who may be expected to profit most from the gathering of logs at the lowest cost and without environmental safeguards") deserves the same if not greater level of protection as does the potential injury to "individual *private* rights resulting from the creation of unfairly constituted public boards."[11]

In support of its conclusion, the *Bayside Timber* court cited the decision of the California Supreme Court in *State Board of Dry Cleaners v. Thrift-D-Lux Cleaners*,[12] wherein the Court struck down a statute allowing the Board to establish minimum price schedules for the dry cleaning industry. Noting that the Board was dominated by members of the industry (by a 6-1 majority), the Supreme Court ruled that the make-up of the Board was unreasonable and a constitutionally invalid exercise of the state's police power. "Where the Legislature attempts to delegate its powers to an administrative board made up of interested members of the industry, the majority of which can initiate regulatory action by the board in that industry, that delegation may well be brought into question."[13]

Unconstitutional Enforcement. Whereas the *Bayside Timber* and *Thrift-D-Lux* courts considered issues of unfair agency rulemaking due to an improperly-constituted board, other courts have focused on issues of unfair agency adjudication/enforcement action by boards controlled by members of the very industry being regulated. In *Gibson v. Berryhill*,[14] the U.S. Supreme Court found that the Alabama Board of Optometry was an unfair tribunal for purposes of instituting adjudicatory proceedings against competitor licensed optometrists. The Board, which consisted exclusively of private-practice optometrists, instituted disciplinary actions against several licensed optometrists who were employed by business corporations. The respondent corporate optometrists filed a civil rights action in federal court in an attempt to enjoin the Board's disciplinary proceedings. The district court halted the Board's action on two grounds: (1) prejudgment (the Board had previously filed a complaint in state court against these same corporate optometrist respondents, alleging unlawful practice of optometry and unprofessional conduct); and (2) pecuniary interest (the court found that the respondent corporate optometrists accounted for nearly half the practicing optometrists in Alabama; if the licenses of these optometrists were revoked, the private practitioner board members would personally benefit).[15]

In enjoining the Board's license revocation action, the Supreme Court held: "[a]rguably, the District Court was right on both scores, but we need reach, and we affirm, only on the latter ground of possible personal interest."[16] Citing the landmark cases of *Tumey v. Ohio*[17] and *Ward v. Village of Monroeville*,[18] the Court stated that "[i]t is sufficiently clear from our cases that those with substantial pecuniary interest in legal proceedings should not adjudicate these disputes." Further, the Supreme Court cited the district court's reasoning that "the inquiry was not whether the Board members were 'actually biased but whether, in the natural course of events, there is an indication of a possible temptation to an average man sitting as a judge to try the case with bias for or against any issue presented to him.'"[19]

Similarly, in a series of cases, California courts have considered the constitutionality of the composition of the New Motor Vehicle Board (NMVB) for purposes of adjudicatory decisionmaking. In *American Motors Sales Corp. v. New Motor Vehicle Board*,[20] the Third District Court of Appeal considered a challenge to the make-up of the NMVB, which in 1973 was authorized to adjudicate disputes between new car dealers and manufacturers. In just such a dispute, the NMVB ruled that a manufacturer's termination of a dealer's franchise was "without good cause." The manufacturer appealed the ruling on grounds that the Board—consisting of four dealer members and five public members—was constitutionally disqualified from deciding such cases on grounds of institutional bias. The court held:

> The conclusion is unavoidable that dealer-members of the Board have an economic stake in every franchise termination case that comes before them. The ability of manufacturers to terminate any dealership, including that of a Board member, depends entirely upon the Board's interpretation of "good cause." ... [T]he objectionable feature of dealer-membership on the Board is the distinct possibility that a dealer-manufacturer controversy will not be decided on its merits but on the potential pecuniary interest of the dealer-members.[21]

The court held that, for purposes of resolving dealer-manufacturer disputes, the statutory composition of the NMVB deprived manufacturers of their due process right to a fair and impartial tribunal due to a combination of four factors: (1) the required presence of dealer-Board members; (2) the lack of any counterbalance in mandated manufacturer members; (3) the nature of the adversaries in all cases (dealers against manufacturers); and (4) the nature of the controversy in all cases (dispute between dealer and manufacturer).

As the Board of Accountancy has argued in *Moore*, the NMVB protested that the mere presence of industry members on a board empowered to both adopt rules and adjudicate does not rise to the level of a constitutional violation, and that "a disqualifying bias may not be inferred from the mere circumstance of the adjudicator's private life."[22] The Third District rejected this argument on several grounds. First, the court held that the legislature erred in enacting the 1973 amendment expanding the NMVB's jurisdiction to include the adjudication of disputes between dealers and manufacturers, while maintaining the Board's prior composition (which included no manufacturer representatives). "This legislative partisanship damns the Board. The State may not establish an adjudicatory tribunal so constituted as to slant its judicial attitude in favor of one class of litigants over another. By doing so in this instance, the Legislature violated its obligation to assure evenhandedness in the adjudicatory process."[23]

Second, the court noted that "we do not rest our holding upon simple status. Because the challenged Board members have a 'substantial pecuniary interest' in franchise termination cases (cf. *Gibson v. Berryhill, supra*), their *mandated* presence on the Board potentially prevented a fair and unbiased examination of the issues before it in this case, in violation of due process."[24]

Third, the court ruled that the presence of some non-industry members on the Board does not cure the constitutional defect. "The evil here lies in the state's insistence that under all circumstances the adjudicatory deck of cards be stacked in favor of car dealers. That evil is not eliminated by stacking the deck four-ninths of the way rather than all the way."[25] Thus, the court indicated sensitivity to the fact that dealer-members might exert undue influence on the sensibilities and votes of public members.

Subsequent to the Third District's opinion in *American Motors*, the legislature amended the NMVB statute to eliminate dealer-member involvement in NMVB disputes between dealers and manufacturers.[26] But in 1979, the legislature amended the statute again to provide that dealer-members "may participate in, hear, and comment or advise other members upon, but may not decide" any matter involving a dealer-manufacturer dispute.[27] This provision was also declared unconstitutional for failing to guarantee due process in *Chevrolet Motor Division v. NMVB*[28] and *Nissan Motor Corp. v. NMVB*.[29] These courts openly recognized the persuasive influence which industry members may be expected to wield in conducting agency business:

> Because of their ongoing working relationship, public members of the Board may be influenced by arguments or facts suggested by the dealer members but not included in the public record, and the parties themselves may not have the opportunity to respond. In short, the presence of biased members on the Board presents a substantial probability that decisions in dealer-manufacturer disputes will be made on the basis of inappropriate considerations, and the fact that those members do not technically "decide" the disputes does not alter that probability. Each of the factors in *American Motors* is still present.[30]

Due Process Principles Compel the Invalidation of Rule 2. The fairness principles illustrated in these cases are easily applied to *Moore*. In *Bayside Timber*, the timber-industry-controlled Board of Forestry adopted rules suggested by timber-industry-controlled regional committees and approved by two-thirds of the timber industry in the regions. Those rules invariably favored the timber industry to the detriment of the general public and other interests ostensibly sought to be protected by the Forest Practice Act. In *Gibson*, an optometry board controlled by one segment of the profession targeted another segment of that profession for enforcement proceedings. Both actions were invalidated on due process grounds.

Here, the Board of Accountancy in 1948—comprised of five licensed accountants, *no* public members, and *no* members representing unlicensed accountant practitioners lawfully rendering services under Business and Professions Code section 5062 (now 5052)—conducted formal rulemaking proceedings and adopted a regulation with the force of law which prohibits another kind of accountant from using the term "accountant" or "accounting" to describe his/her services. The Board then abused its enforcement powers by issuing cease and desist letters and threatening criminal prosecution. It further has the statutory authority to levy citations and fines against licensees and *non*licensees who violate Board statutes or regulations.[31] As testified to at the *Moore* trial, that rule and its enforcement has a detrimental impact on the ability of non-CPA accounting practitioners to advertise their services to those most in need of them through the usual means of advertising—the telephone directory under the heading "Accountant."

There is no question that Bonnie Moore (who has a college degree in accounting and twenty years' experience in the accounting field) and the other plaintiffs perform only the acts allowed them in section 5052 of the Business and Professions Code; there is also no question that the term which most accurately and truthfully describes those lawfully-performed acts is "accounting" or "accountant." The Board does not contend that Bonnie Moore or the other plaintiffs have ever represented themselves to be "certified public accountants" or "public accountants." They seek only to render the services permitted them under section 5052 of the Business and Professions Code, and to exercise constitutionally protected commercial speech rights by truthfully advertising the availability of those services in the manner most familiar to those who would be their customers. Yet their competitors—CPAs who dominate the Board of Accountancy, who have a substantial pecuniary interest in preventing independent accountants from advertising in the usual manner and providing those services, and who stand to gain from that inability to so advertise and so practice—have adopted and are attempting to enforce a rule which stands to wipe out the practice of unlicensed accountancy expressly permitted by the legislature. The *Bayside Timber* and *Gibson* courts would invalidate that anticompetitive and unfair rule; so should the Supreme Court now considering it.

Rule 2 is Anticompetitive and Harms the Public Interest. The formal audit, with its accompanying certified opinion of soundness, is the only accounting function reserved exclusively to Board licensees.[32] However, less than 20% of CPA firms perform these audits as their main source of income.[33] Most certified public accountants compete with unlicensed individuals and firms for the wide range of overlapping accounting services sought by consumers. That is, **CPAs and unlicensed accountants directly compete for at least 80% of the accounting business in the marketplace; both licensees and nonlicensees seek to perform the identical services.** By excluding independent accountants from advertising or describing themselves as "accountants," the Board has effectively limited competition for non-audit clients. The industry-dominated Board has allowed its substantial pecuniary interest to outweigh the strong policy against anticompetitive agency conduct illustrated in *Gibson, Bayside Timber*, and *Thrift-D-Lux*.

That the Board's Rule 2 harms Bonnie Moore and other independent accountants, to the benefit of CPAs permitted to easily and accurately advertise those same services, is clear. But it also harms the general public, the small business, the farmer, the sole practitioner, the individual in need of the accounting services described in Business and Professions Code section 5052 but without the wherewithal (or need) to pay a CPA. This interest was recognized as valid and deserving of protection in *Bayside Timber* and should be equally recognized by the Supreme Court in *Moore*.

Under section 5052, unlicensed accounting firms may lawfully perform the services usually required by the general public. These services are available from licensee accounting firms which may readily advertise in an accessible manner, but the hourly fee may be more than double that of Bonnie Moore and other plaintiffs. While licensees must be qualified to perform highly technical audits, the usual individual or small business has no need for those sophisticated skills (and they clearly should not be required to pay for them, or for the substantial overhead costs incurred by licensed CPA firms). Unlicensed firms such as Bonnie Moore's Accounting Center are not permitted to and do not perform at that technical and complex level, yet they are restricted from truthfully reaching those most in need of their services. When consumers who require accounting services are prevented from locating an entire class of providers, it is they who suffer irreparable harm—not the Board-licensed CPAs who adopted Rule 2 and have threatened criminal prosecution to enforce it.

The Board contends that the use of the term "accountant" or "accounting" by nonlicensees is deceptive and misleading; however, it is the *Board's* restriction of the use of that term which is shamefully misleading. Under the

Board's Rule 2, only Board licensees are "accountants" and may legally advertise "accounting" services. The Board ignores the fact that the legislature has reserved a wide range of accounting services for nonlicensees, and has *not* precluded nonlicensees from using the term "accountant" or "accounting." The Board's message to the public—that only Board-licensed CPAs are "accountants"—is legally erroneous, factually inaccurate, and a regrettable but all too common reflection of cartel self-interest. Most troublesome, this cartel is operating in the garb of a state agency with an obligation to protect the public. The question is, how do we hold accountable a state agency of accountants expropriating public power for private self-aggrandizement?

FOOTNOTES

1. *Moore v. California State Board of Accountancy*, 222 Cal. App. 3d 919, 272 Cal. Rptr. 108 (Aug. 1, 1990), *pet'n for rev. granted*, __Cal. 3d__, No. S017399 (Oct. 18, 1990).
2. Business and Professions Code § 5000 *et seq.*
3. Section 2, Chapter 1, Title 16, California Code of Regulations.
4. 411 U.S. 564 (1973).
5. *See, e.g., State Board of Dry Cleaners v. Thrift-D-Lux Cleaners*, 40 Cal. 2d 436 (1953); *Nissan Motor Corp. v. New Motor Vehicle Board*, 153 Cal. App. 3d 109 (1984); *Chevrolet Motor Division v. New Motor Vehicle Board*, 146 Cal. App. 3d 533 (1983); *American Motors Sales Corp. v. New Motor Vehicle Board*, 69 Cal. App. 3d 983 (1977); *Allen v. California Board of Barber Examiners*, 25 Cal. App. 3d 1014 (1972); *Bayside Timber Company, Inc. v. Board of Supervisors of San Mateo*, 20 Cal. App. 3d 1 (1971).
6. Business and Professions Code § 5058.
7. 20 Cal. App. 3d 1 (1971).
8. *Id.* at 14.
9. *Id.* at 10.
10. *Id.* at 14.
11. *Id.* (emphasis original).
12. 40 Cal. 2d 436 (1953).
13. *Id.* at 449. *See also Allen v. California Board of Barber Examiners*, 25 Cal. App. 3d 1014 (1972) (in a case indistinguishable from *Thrift-D-Lux*, the Fourth District Court of Appeal struck down minimum price schedules established by the Board of Barber Examiners consisting of four barbers and one public member).
14. 411 U.S. 564 (1973).
15. *Id.* at 578.
16. *Id.* at 579.
17. 273 U.S. 510 (1927) (mayor-judge with personal pecuniary interest in outcome of liquor law violation cases ruled unfair tribunal for such cases).
18. 409 U.S. 57 (1972) (mayor-judge with only indirect pecuniary interest in convictions resulting in fines ruled unfair tribunal).
19. Gibson, 411 U.S. at 571. *See also State Board of Dry Cleaners v. Thrift-D-Lux Cleaners, Inc.*, 40 Cal. 2d 436, 448 (1953), in which the California Supreme Court discussed and approved of language in *Becker v. State*, 185 A. 92 (1936), a Delaware Supreme Court case invalidating the Delaware Dry Cleaning Law and noting that "vast authority is centered in a governing board, a majority of which are directly interested in the industry, but who, nevertheless are empowered to act in a judicial capacity, and to sit in judgment over fellow members of the trade. Too great a strain is imposed upon human frailty. The practical tendency of the legislation is to create and foster monopoly, to prevent, not to encourage, competition, to maintain maximum, not minimum prices, all of which is against, not in aid of, the interests of a consuming public."
20. 69 Cal. App. 3d 983 (1977).
21. *Id.* at 987-88.
22. *Id.* at 992.
23. *Id.* at 991.
24. *Id.* at 992 (emphasis original).
25. *Id.* at 993.
26. Chapter 278, Statutes of 1977.
27. Chapter 240, Statutes of 1979 (amending Vehicle Code sections 3050(d) and 3066(d)).
28. 146 Cal. App. 3d 533 (1983).
29. 153 Cal. App. 3d 109 (1984).
30. *Id.* at 115, *citing Chevrolet Motor Division*, 146 Cal. App. 3d at 541.

Following the courts' rulings in *Nissan* and *Chevrolet Motor Division*, the NMVB adopted a policy of voluntary recusal of dealer-members from discussions of dealer-manufacturer disputes. This policy was held insuffiecent to cure the constitutional defect in *University Ford Chrysler-Plymouth v. NMVB*, 179 Cal. App. 3d 796 (1986). Perhaps anticipating that result, the legislature in 1985 amended the statute to its present form, providing that dealers "may not participate in, hear, comment, advise other members upon, or decide" any matter involving dealer-manufacturer disputes. In *American Isuzu Motors, Inc. v. NMVB*, 186 Cal. App. 3d 464 (1986), the court held this finally cured the constitutional defect.

31. Sections 125.9 and 125.95 of the Business and Professions Code permit the Board of Accountancy to establish by regulation a system for issuance of citations and fines to licensees and nonlicensees which violate the Board's statutes or regulations. In February 1990, new section 95.6 of the Board regulations became effective. Under this section, the Board's Executive Officer is permitted to issue citations containing orders of abatement and administrative fines up to $2,500 per investigation against unlicensed persons who are performing acts for which licensure is required.
32. Business and Professions Code § 5051(d); *see also* officially recorded comments of James R. Sullos, Jr., CPA Member, State Board of Accountancy Meeting at Oxnard, California (Jan. 27-28, 1989), Board's minutes at 4420.
33. California Society of Certified Public Accountants' (CSCPA) Task Force on Certification Requirements, presented to State Board of Accountancy at Oxnard, California (Jan. 27-28, 1989).